Railroad Bonds

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THE capitalization of the railroads of the United States is nearly twenty billion dollars, of which nearly two-thirds is represented by bonds and the balance by stock. Up to about ten years ago railroad securities formed the bulk of the transactions on the Stock Exchange, and the money invested in these securities was more convertible into ready cash than money invested in most other enterprises; in fact, previous to the formation of a number of our large industrial companies in 1900, railroad securities were substantially the only securities which enjoyed a broad market on the Stock Exchange.

The gross earnings of our railroad companies have doubled in every twelve or fifteen years. With this steadily increasing business, which grew beyond all expectations, the constant investment of additional capital is, of course, necessary. To provide for consolidation and this rapid expansion, additional mortgage liens were created, and thus ensued the complicated structure of securities resting on many of the older railway systems. Up to about 1890 the expansion of the transportation business had not been sufficiently visualized, and nearly all mortgages made were closely limited to the requirements of the corporations at the time of the creation of such mortgages. From 1887–90 several large railroad corporations were reorganized and new mortgages created, which did not provide one dollar of additional money for expansion. This was the case in the reorganization of the Wabash, the Missouri, Kansas & Texas, the Atchison, Topeka & Santa Fé, and others. When the traffic grew these companies were unable to raise additional money by the sale of stocks or junior mortgages and in many cases went into bankruptcy because they could not get the necessary capital on fair terms.

Since 1900 mortgages have grown larger and larger. In 1898 the state of New York for the first time permitted the investment of trustees and savings bank funds in railroad bonds. Since that time a number of other states have followed this example. The laws of most states require that only such bonds are available as a legal investment for trustees and savings banks as are secured by mortgages, which are obligations of companies that have paid not less than 4 per cent dividends for a period of not less than five years on a capital stock which must not be less than one-third of the bonded debt. In other words, the limit of bonded debt recognized as being safe is a capitalization represented by about three-fourths of its capital value in bonds and one-fourth in stock. As a consequence of this legislation several of our larger railroad companies, like the Pennsylvania, the New York Central and the Baltimore and Ohio have executed what is known as an *open mortgage*, under which bonds may be issued from time to

time whenever the company may need money for the purpose of paying off prior lien bonds or for raising additional capital. The amount of such bonds outstanding, however, shall never be more than three times the amount of the outstanding stock of the corporation.

Forms of Mortgages

The art of drawing railroad mortgages has made progress in many directions. At first, mortgages were secured by deeds of trust similar in all respects to the real estate mortgages then in vogue. Gradually the needs of the situation evolved a different type of trust deed, and now some of these very formidable documents run up to one hundred fifty pages and more. Formerly the mortgage was given to an individual the same as in real estate transactions; now mortgages are executed to corporate trustees in practically every instance. The advantage of a corporate trustee is that it never becomes sick, nor dies. As many complicated questions may arise with the trustees, but there is a clause in every trust deed defining the duties of the trustee and holding the trustee harmless against everything except malfeasance or breach of trust. Whenever it is necessary to do so, bondholders, in order to assert their rights under a mortgage, must get together, because very seldom is the trustee required to take any action on any subject connected with the mortgage except at the request of holders of not less than one-quarter of the outstanding bonds. On the other hand, a majority of the bonds, in most cases, can direct the trustee to take action, that is, declare due the principal of a mortgage in case the interest or principal is not paid when due, in case the property has not been properly maintained, or in case a receiver is appointed, etc.

The deed of trust generally contains provisions under which the corporations agree to maintain the property, pay promptly taxes, rentals, etc. It has been found in many of the recent reorganizations that the properties had not been properly maintained and that the equipment and other items had been allowed to deteriorate. Under the trust deed the trustee was not obligated, nor provided with funds for matters of this kind. This subject has been taken up by the Investment Bankers Association of America and discussed considerably at the annual meetings. Some method is being sought to keep the bondholders in closer touch with the conditions of their mortgaged property.

Bondholders' Committees

The bulk of railroad bonds are coupon bonds payable to bearer, hence after they have become thoroughly distributed it is extremely difficult to locate them. It is for this reason that the modern bondholders' committee has been evolved. Whenever companies get into trouble or whenever it is necessary for bondholders to combine for purposes of protecting their interests, a committee is formed. This committee is usually composed of representatives of one or more firms who distributed the bonds in question and of representatives of the large bondholders. These committees always request holders to deposit their bonds with some trust company under an agreement which gives the committee full power to deal with the de-

posited bonds as may seem proper.

The bondholders' deposit agreement, like the trust deed or mortgage, is also a document which has undergone considerable change to meet the decisions rendered by courts from time to time. The courts, in all cases, have interpreted the powers of a committee as powers in trust and have held committee members strictly liable as trustees.

As a rule, reorganization progresses much slower than is anticipated, due, largely, to protracted litigation which is frequently carried on by the defendant in order to gain as much time as possible, in the expectation that time will tire out the creditors or that financial conditions may improve in the meanwhile. Bondholders have felt in some cases that the committee was taking an undue length of time in which to accomplish its work and have brought suit for the return of their bonds. The courts have been inclined to hold that, whenever no definite time was mentioned, five years was a reasonable time to work out a situation, and that, generally speaking, bondholders should be entitled to the return of their securities if the committee has not achieved anything within that period.

Decline in Railroad Credit

During the last ten years railroad securities have not been so popular as previously, and the decline in price has been due to the following reasons:

1. As money became dearer with the expansion of commerce, and later owing to the war, many prime bonds have declined in value commensurate with the rise in the value of money.
2. As restrictions and regulations of railroads by the forty-eight state and federal authorities became more and the more complex and profits more and more circumscribed, investors felt that securities of corporations, whose profits are limited by public opinion and by law, were not a desirable investment.
3. The railroads, in order to educate the public to their needs and thus influence legislators, were compelled to announce their poverty broadcast and they thereby educated the investing class, also, on this subject.
4. The rising cost of labor and the fact that Congress and state legislators were trying to help labor get increased wages, and at the same time were not willing, presumably at the behest of another class of voters, namely, the farmers and shippers, to advance rates commensurately with increased wages and costs of material, is another cause of unpopularity.
5. The normal income tax and super tax imposed on railroad securities which are not being imposed on state and municipal securities accounts for further decline in price.

Excessive Income Taxes

The average bond buyer, averaging a large number of small bondholders and a comparatively small number of rich men, has probably an income in excess of $30,000 per annum. If this income is derived from railroad and other corporation bonds it is subject to a tax of 13 per cent, hence—about one-seventh of the income must be paid over to the government. Naturally a bond buyer wants to be compensated for this tax by a greater return on securities subject to it. The tax on incomes above $30,000 increases very rapidly.

An income of \$40,000 is subject to a tax of nearly 16 per cent.

An income of \$60,000 is subject to a tax of about 21 per cent.

An income of \$100,000 is subject to a tax of about 31 per cent.

An income of \$150,000 is subject to a tax of over 40 per cent, etc.

People with large incomes, therefore, can only afford to buy railroad bonds when compensated by an extraordinarily large return.

Pending Railway Legislation

A bill is now pending before the Conference Committee of the two Houses of Congress, which is expected to be enacted into a law before this article is published. Under this law the railroads, which are to be returned by the government on the 1st of March to the corporations owning them, will be guaranteed the standard return or rental by the government for another six months, and during that period they will be requested to ask for an advance of rates which will enable them, as a whole, to earn sufficient money to pay their operating expenses, maintenance, taxes and a fair return on their value. This fair return may possibly be limited to 5½ per cent, or it may be left to the discretion of the Interstate Commerce Commission.

Presumably, by a fair return is meant the income which will make the securities worth their face value under average conditions. With the enormous changes which have come over the world in every way, including the value of money, it is very difficult to determine what is the fair average value of money. In the city of Cleveland, under the contract between the city and the local street railway company, based on service at cost, the company was allowed 6 per cent dividends on its stock. This amount was recently increased to 7 per cent, so as to enable the company to sell additional stock at par in order to raise the necessary money for expansion.

At present what are considered to be safe dividend paying stocks are selling at prices to yield close to 8 per cent. Many bonds which formerly sold at prices to yield less than 4 per cent can now be bought at prices to yield 7 per cent. It would appear, therefore, that nothing less than 7 per cent would be a fair rate of interest under present conditions. As most corporations have at least one-half of their investment represented by bonds paying not to exceed an average of 5 per cent interest, the assumption of our lawmakers is that a return of 5½ per cent on the entire capital invested would be equal to 5 per cent on bonds and 6 per cent on the capital stock. In cases where companies have 4 per cent bonds outstanding, a return of 5½ per cent on the entire capitalization would work out 7 per cent on the stock. Under prevailing conditions 5½ per cent would not appear adequate because a 7 per cent return on good stocks would hardly enable railroad companies to sell large amounts of the same at par. The companies, under the law, are not permitted to sell their stock below par. To raise the required capital for expansion they must sell stock at par or further increase their indebtedness which, in most cases, is already unduly large.

The Problem of Valuation

There is still another important problem left open. On what sum shall this

fair return be payable? Congress, the Interstate Commerce Commission and many state commissions have denied that the value of the stocks and bonds of the various railroad companies represent a fair value of the property, and it has been asserted that a fair value is only one-half of the capitalization or even less. It is this question of value which prompted Congress to pass the valuation act some years ago, under which the physical value of all railroad properties was to be determined. It appears to be the intention of Congress that the fair return shall be based on physical valuation. While this valuation will not be completed for another two or three years, it has made sufficient progress to indicate that, on the whole, even at prices prevailing before the war, the railroads were rather undercapitalized. The valuation of a few of the minor roads has been completed and while the results are seriously questioned by the corporations, the valuation in each case has worked out considerably more than the present market price of the securities. In the end it will certainly be determined that not less than 95 per cent of all railroad bonds issued in the United States are issued within physical valuation, and that, therefore, the properties on which they are a lien are entitled to earn a fair rate of interest. In a few isolated minor cases the lines may be so located that the companies would not be able to do so, in spite of the opportunity which will be granted to them under the law, but, at any rate, railroad bonds are certain to become what might be called "validated" and will get a clean bill of health.

As far as railroad stocks are concerned, it will certainly be found that the stocks of many corporations represent very much more than par value, for instance, those of the Pennsylvania Railroad, New York Central, Chicago, Burlington & Quincy, Louisville & Nashville, Union Pacific, Chicago & North Western, etc. On the other hand, the valuation of other roads will produce a result showing considerably less than the par value of the stocks, but the average of all railroad stocks will probably be not far from par.

Condition of Our Transportation System

In the summer of 1914 when the world's war started we were in a period of depression which, in the opinion of many, was due mostly to the fact that the largest consumers of materials, the railroads, were spending as little money as possible, owing to the poor condition of their credit. Subsequently, while business improved, railroad credit did not improve, and up to the time the federal government took over the railroads, less than the usual amount for additional equipment and improvements had been spent by the railroad companies. Since then, that is, during the year 1918, the government, owing to war conditions, has made only such improvements as were necessary for war purposes, and has bought about the average amount of cars and locomotives necessary for that year. In 1919, Congress appropriated only a comparatively limited amount of money for additional facilities. Thus far in 1920, nothing has been done. As a consequence, with the largest volume of business on record, railroad facilities are utterly inadequate; in fact, these facilities are likely to be inadequate for several years, until the

average annual expenditure of approximately one billion dollars for expansion has been made good. During the last five and one-half years less than one-half of the requisite amount has been so expended. The railroads will start in to make these necessary improvements during the latter half of 1920, if they can get money on fair terms. If they cannot get it, we will have a serious reaction in business, our commerce will be hampered and the general growth of business blocked. Therefore, constructive railroad legislation is the most important question before the country. Proper railroad legislation should and must establish a broad credit for the railroad companies in order to enable them to get at reasonable rates, commensurate with the money market, the additional capital required. Such legislation must strengthen outstanding bond issues, because otherwise the companies cannot sell more bonds or stock.

Prices of Securities Follow Earnings

During the last six months prices of securities have been adjusted somewhat to the result of operations of the various railroad companies under government management. Railroads which formerly showed a large surplus above interest charges have failed, in many cases, under government management, to earn even all of their operation expenses. Discriminating buyers have refused to buy securities of roads which have failed to earn interest charges, and stocks and bonds of these companies have consequently declined. The management of nearly every railroad expects to re-establish its former business and to handle substantially the same proportion of business as formerly. If this should be the case then the prices of bonds, which have declined as a consequence of the poor showing under government management, are bound to show a considerable recovery, especially in connection with the valuation above referred to. Seasoned railroad securities, which in many cases can be bought at prices to yield up to 9 per cent, certainly must show a large recovery, even under present money market conditions, just as soon as proper legislation is enacted by Congress, and when the coming increase in freight rates becomes effective.